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The Emperor's New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK's Stewardship Code

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John Kingman's review of the Financial Reporting Council (FRC) doubted the effectiveness of the UK's Stewardship Code in encouraging informed and engaged stewardship by institutional investors of the companies in which they invest (issuers). Accordingly, the FRC updated the Stewardship Code in 2020 in a final bid to prove its effectiveness and relevance, and, in particular, to enhance issuer-specific engagement by institutional investors. The update has enhanced the reach and substance of the Code. However, the legal, regulatory, contractual and competitive environment in which institutional investors exist will constantly forestall soft-law attempts to foster greater issuer-specific engagement, a point perhaps tacitly acknowledged by the 2020 Stewardship Code with its wider scope. Instead, in relation to engagement, stewardship disclosure should focus on the types of engagement that institutional investors are motivated to exercise in practice, such as engagement in response to hedge fund activism, and engagement on systemic risks.

INTRODUCTION

'The Emperor's New Clothes'[1] tells the classic tale of an emperor who receives a set of 'clothes', described by deceitful weavers as invisible to the unworthy. The emperor, not wishing to appear underserving, proceeds to 'wear' an outfit that does not exist. In 2020, the UK's Stewardship Code, on its tenth anniversary, was also presented with a sartorial gift, with the Code substantively updated and expanded by the Financial Reporting Council (FRC) in an attempt to increase the effectiveness with which shareholders engage with the companies in which they are invested (issuers).[2] This article discusses whether the new version of the Stewardship Code will in fact encourage the types of engagement coveted by the FRC, or whether, in repeating the shortcomings of previous versions of the Code, it merely pulls the wool over the emperor's eyes.

The word 'stewardship' stems from the old English term for a housekeeper, or, more appropriately in the context of this article, someone who looks after

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1 Hans Christian Anderson, *Eventyr, fortalte for Børn. Første Samling. Tredie Hefte* (*Fairy Tales Told for Children. Third Booklet*) (Denmark: C.A. Reitzel, 1837).
2 FRC, *The UK Stewardship Code 2020* (London: FRC, 2020) (2020 Code).

the house.[3] Stepping into contemporary times, in the finance world, stewardship has been used to define the concept that those who look after the assets of others, should act as good 'stewards' of those assets.[4] Accordingly, institutional asset owners, such as pension funds, insurance companies, investment funds and other collective investment vehicles, which invest funds on the behalf of 'beneficiaries', should take care of those funds and of the assets and companies in which those funds are invested. In the wake of the 2008 financial crisis, the ideal of investor 'stewardship' took a grip, with the publication of the influential 'Walker Review'.[5] The supposition[6] was that the banks, which failed during the financial crisis, had taken unwarranted risks to enhance short-term profits, which could have been attenuated if, as listed entities, their institutional investors had proactively monitored or 'stewarded' their actions and strategies. After all, the banks, in which asset owners invested, represented the assets of the beneficiaries which the asset owners had been tasked to steward. In 2010, the FRC published the UK's Stewardship Code,[7] which outlined a number of principles to which 'institutional investors' should adhere.[8] Institutional investors, which hold nearly 80 per cent of UK-listed shares,[9] were denoted to be asset owners, as described above, and the asset managers who manage assets on behalf of their 'clients', the asset owners.[10] The principles encouraged institutional investors to monitor and engage with the boards of issuers, and to disclose their policies on stewardship and voting.

Even though the Code was up-dated in 2012, a great deal of scepticism has been levelled at its effectiveness over the years,[11] culminating in the scathing criticism of the independent 'Kingman Review',[12] which, in 2018, generally reviewed the effectiveness and role of the FRC.[13] The Kingman Review

3 'Stewardship' derives from the old English words, stig ('house hall') and weard ('ward') (J. Pearsall (ed), *Concise Oxford Dictionary Tenth Edition* (Oxford: OUP, 1999).

4 An example of a relevant definition: 'Stewardship is the "responsible and wholehearted management of entrusted assets so as to pass them on in better condition".' (O. Hwee and M. Goyder (eds), *Entrusted: Stewardship for Responsible Wealth Creation* (Singapore: World Scientific, 2020) 21.

5 D. Walker, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (London: HM Treasury, 2009) (Walker Review).

6 *ibid*, 72.

7 FRC, *The UK Stewardship Code* (London: FRC, 2010) (Stewardship Code 2010).

8 Service providers to those institutional investors were also encouraged to 'disclose how they carry out the wishes of their clients by applying the principles of the Code that are relevant to their activities' (*ibid*, 2).

9 If individuals, charities and public sector bodies are excluded, UK and global institutions hold the remainder of UK equities, amounting to 77.77 per cent of UK-listed shares (Calculated using data from: Office for National Statistics (ONS), 'Ownership of UK quoted shares: 2018' (January 2020)).

10 Stewardship Code 2010, n 7 above, 2.

11 For example Business, Innovation and Skills (BIS) Committee Third Report of Session 2013-14, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (London: BIS, 2013) 37; A. Reisberg, 'The UK Stewardship Code: On the Road to Nowhere' (2015) 15 JCLS 217; D. Arsalidou, 'Shareholders and Corporate Scrutiny: The Role of the UK Stewardship Code' (2012) 3 ECFR 342, 355-371.

12 J. Kingman, *Independent Review of the Financial Reporting Council* (London: DBEIS, 2018) (Kingman Review).

13 In accordance with the Kingman Review's recommendations (*ibid*, 19), the FRC will be replaced by the Audit, Reporting and Governance Authority, a new independent regulator established on a statutory footing.

castigated the Stewardship Code's lack of efficacy in encouraging informed and engaged stewardship of issuers by UK-investors,[14] and suggested that the Code acted as a driver of boilerplate reporting due to the FRC focusing on the quality of policy statements by institutional investors, rather than the outcomes and effectiveness of stewardship in practice.[15] Ominously, the review asserted that if a revised Code could not more clearly differentiate excellence in stewardship, serious consideration should be given to its abolition.[16]

Although the broader concept of stewardship embraces a vast array of potential actions, this article will focus on 'engagement', being the centre of attention of both the Walker and Kingman Reviews. The clear recommendation of the Walker Review was that institutional investors should proactively engage with the boards of their individual investee companies to pre-emptively identify and resolve strategic problems, and ensure that those companies are managed successfully – what will, in this article, be termed 'issuer-specific engagement'. Successive editions of the Stewardship Code encouraged issuer-specific engagement as the primary method of effective stewardship,[17] and the Kingman Review alluded to an absence of meaningful engagement by institutional investors.[18] Issuer-specific engagement has been a cornerstone of the stewardship movement, but, as will be discussed, it may be time to take a step back to determine what types of engagement are most likely to occur, and, indeed, what types of engagement are propitious.

When it comes to engagement, with the publication of the UK Stewardship Code 2020[19] (the 2020 Code), the FRC has kicked open the swing-doors to last chance saloon. The FRC has endeavoured to rectify flaws in the previous version of the Code, including greater recognition that the interests of beneficiaries and clients may be served by broadening the concept of stewardship to more than issuer-specific engagement, but in tribute to the Walker and Kingman Reviews, issuer-specific engagement is still front-and-centre. In this article, it will be discussed that although the 2020 Code has improved upon previous deficiencies, the traditional premise of investor engagement on issuer-specific matters as first envisaged by the Walker Review is fundamentally fated to fail. The 2020 Code's wider ambit beyond issuer-specific engagement is a tacit admission that investor engagement may not be achievable in the manner advocated by the Walker and Kingman Reviews, and a broader scope has been adopted in an attempt to salvage the Code's relevance. That broader scope may, in fact, lay the foundations for future regulatory policy that focuses on the types of engagement that take place in practice, rather than the traditional form of issuer-specific engagement as advocated by previous versions of the Stewardship Code. This article will commence with a brief overview of the material changes to the Stewardship Code introduced by the 2020 Code, followed by a description of the legal, regulatory, contractual and commercial duties of institutional investors which will be critical in assessing the efficacy of the 2020 Code

14 *ibid*, 8.
15 *ibid*, 46.
16 *ibid*, 46.
17 nn 26-28 below, and accompanying text.
18 nn 14-16 above, and accompanying text.
19 n 2 above.

to promote engagement. The propensity for asset owners and asset managers to exercise issuer-specific engagement will be analysed, and it will be concluded that the principle type of issuer-specific engagement that will occur in practice is that exercised by offensive activists such as hedge funds – a sub-set of institutional investors that are not targeted by, and are not generally signatories to, the Stewardship Code. As such, the Stewardship Code should, instead, focus on the dynamic between such offensive activists and those institutional investors more likely to become signatories to the Stewardship Code. Finally, the prospects for the broader scope of the 2020 Code to promote engagement of another kind which relates to engagement across multiple issuers or across an industry as a whole – categorised in this article as holistic-risk engagement – will be determined, and the consequences of that insight for the future of stewardship-related regulation will be evaluated. However, with respect to traditional issuer-specific engagement, it is time to leave that ideology in the tumbleweed.

THE 2020 CODE – WHAT HAS CHANGED?

Although it is not intended that a detailed retrace of the Stewardship Code's history be reproduced here,[20] in this section, a brief outline of the evolution of the Code and the changes introduced by its 2020 incarnation are presented, with a view to discerning whether there has been any palpable shift in the Code's tone which could inform the discussions in the remainder of this article. The FRC first commenced administering the Stewardship Code in 2010, after appropriating an existing code of responsibilities developed by a representative body for institutional investors.[21] The Code was purely voluntary, only applying to those institutional investors who signed-up to the Code,[22] and constituted seven principles against which institutional investors were expected to disclose their compliance or explain their reasons for deviation ('comply-or-explain').[23] As such, it represented the softest of soft-law. Although the 2010 version of the

20 For a history see Arsalidou, n 11 above, 348-352; B. Cheffins, 'The Stewardship Code's Achilles Heel' (2010) 73 MLR 1004, 1008-1013; I. Chiu and D. Katelouzou, 'From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?' in H. Birkmose (ed), *Shareholders' Duties* (Alphen aan den Rijn: Kluwer Law International, 2016) 131, 134-135; P. Davies, 'The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?' ECGI Working Paper No 506/2020 1, 4.

21 The Stewardship Code 2010, n 7 above, replicated a code that had been developed by the Institutional Shareholders Committee (ISC), the 'Code of Responsibilities of Institutional Investors', which itself was based upon the long-running 'Statement of Principles of Shareholder Engagement'.

22 There is some compunction, though, on UK-based asset managers, which must be authorised by the Financial Conduct Authority (FCA) to provide investment management services (Financial Services and Markets Act 2000 (FSMA 2000), ss 19 and 22), to sign-up to the Stewardship Code. As a condition of authorisation, either the nature of the asset manager's commitment to the Stewardship Code, or an alternative investment strategy, must be disclosed (FCA's Conduct of Business Sourcebook (COBS), 2.2.3R).

23 Stewardship Code 2010, n 7 above, 1. The Code continued in the tradition of the comply-or-explain regime that applies to the UK's Corporate Governance Code, n 34 below, which was pioneered in 1992 in the 'Cadbury Code' (A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee and Co, 1992) 57).

Code did not include a definition of 'stewardship' *per se*, it did set out the aims of the Code, being, 'to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities'.[24] The seven principles could be broadly delineated into 'reporting' and 'intervention'. The three 'reporting' based principles required disclosure of stewardship policy, voting and stewardship activity, and policy on management of conflicts of interest.[25] The 'intervention' based principles required disclosures that it was hoped would, as implored by the Walker Review, encourage issuer-specific engagement – institutional investors were required to, or explain why they did not, monitor their investee companies, escalate their stewardship activities in accordance with clear guidelines, act collectively with other investors where appropriate, and have a clear policy on voting in those investee companies.[26] In 2012, hot-off the back of criticism by the Kay Review[27] that listed companies and the equity markets in which they issued capital were overly preoccupied with short-term metrics, the Code was updated, and the aims were subtly revised: 'Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper.'[28] Although the aims no longer specifically referenced engagement, only marginal revisions were made to the Principles and Guidance, which therefore remained focused on issuer-specific engagement.

No further changes were made to the Code until 2020. The 2020 Code is still a voluntary code which only applies to those who resolve to become signatories, although, as with previous versions, there is some compunction[29] on UK-based asset managers to sign-up to the Code.[30] The 2020 Code, though, takes a stricter modus than the Code's previous 'comply-or-explain' approach. Now signatories must apply the principles and explain how they have done so ('apply-and-explain').[31] The 2020 Code also recognises the differing roles of asset owners and asset managers, with responsibilities of asset owners linked to the interests of beneficiaries, and the responsibilities of asset managers linked to the interests of their clients, the asset owners. Service providers are covered by a separate set of scaled-back principles. The Code also now notionally covers the stewardship of non-equity investments, although only very little detail is

24 Stewardship Code 2010, n 7 above, 1.
25 *ibid*, 5, Principles 1, 2, and 7.
26 *ibid*, 5, Principles 3, 4, 5 and 6.
27 J. Kay, *The Kay Review of the UK Equity Markets and Long-Term Decision Making: Final Report* (London: BIS, 2012). The Kay Review also noted that asset managers could 'contribute more to the performance of British business … through greater involvement with the companies in which they invest', and that asset managers should have greater incentives to engagement. The Kay Review's proposals to reduce the costs of engagement through collective action led to the formation of the Investor Forum *ibid*, 50 (see n 126 below, and accompanying text).
28 FRC, *The UK Stewardship Code* (London: FRC, 2012) 1.
29 n 22 above.
30 Unsurprisingly, therefore, as of the end of 2019, nearly two-thirds of the signatories to the Stewardship Code were asset managers – 178 asset managers, 105 asset owners (some of whom provide asset management services 'in-house'), and 12 service providers (FRC, 'Tiering of 2012 Stewardship Code Signatories' at https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements). All URLs were last accessed on 14 October 2020 unless otherwise stated.
31 2020 Code, n 2 above, 4.

provided.[32] Perhaps the most notable change is that the 'Guidance' formulation adopted by previous versions has been abandoned in favour of 'Reporting Expectations'. The Reporting Expectations emphasise that signatories, rather than merely summarising their policies in relation to each of the principles as required under previous versions of the Code, must provide examples of how they have applied the principles in practice ('activities') and how those activities have contributed to effective conclusions ('outcomes').

The structural changes to the 2020 Code make it abundantly apparent as to what the FRC was intending to achieve. The aspiration is that signatories will no longer be able to provide vacuous disclosures against broad-based principles that do not inform as to their real-world behaviour, and, instead, will improve the quality, substance and meaningfulness of their disclosures. Although the 2020 Code steers signatories to better quality disclosure, it foregoes a 'best practice approach'. The draft version of the Code that pre-empted the 2020 Code proposed that signatories should 'apply-and-explain' against the Principles and 'comply-or-explain' against best practice provisions,[33] mirroring the approach taken by the UK Corporate Governance Code (UK CGC).[34] When best practice norms are not prevalent in the market place, there is value in the principle/provision comply-or-explain approach to ingrain those best practices.[35] In fact, the Walker Review was optimistic that a stewardship code would lead to best practice being promoted throughout the institutional investor community,[36] and the Kay Review recommended the adoption of 'good practice' statements by asset owners and asset managers.[37] With the FRC determining not to delineate best practice, presumably, the objective is that the market will drive the development of best practice norms, consequent to asset managers disclosing to asset owners how they are applying stewardship in the best interests of the asset owners, and asset owners disclosing to beneficiaries how they are developing stewardship policies, and appointing and monitoring asset managers to apply those policies, in the interests of beneficiaries. The goal is that by bolstering reporting through disclosure of activities and outcomes, beneficiaries and clients will be given more coherent information as to how institutional owners are exercising stewardship in practice, and a virtuous circle will develop whereunder clients and beneficiaries select asset managers and asset owners, respectively, based upon their disclosure of consistent engagement with issuers, which in turn encourages those asset managers and asset owners to exercise more and better engagement. However, with respect to encouraging issuer-specific engagement, the entire approach assumes that such engagement is in the best interests of beneficiaries and clients, and, therefore, beneficiaries and

32 *ibid*, 6.
33 FRC, *Proposed Revision to the UK Stewardship Code: Annex A – Revised UK Stewardship Code* (London: FRC, 2019) 3.
34 FRC, *The UK Corporate Governance Code* (London: FRC, 2018). The provisions of the UK CGC outline corporate governance best practice for companies listed on the premium-tier of the Main Market of the London Stock Exchange (premium-listed companies).
35 B. Reddy, 'Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code' (2019) 82 MLR 692, 705.
36 Walker Review, n 5 above, 83.
37 Kay Review, n 27 above, 48.

clients will attach weight to the level of issuer-specific engagement exercised by asset owners and asset managers, which, as discussed further in this article,[38] are fundamentally flawed assumptions.

Beyond structural changes, the FRC was intent on ensuring that the 2020 Code would constitute more than the merely superficial changes made between 2010 and 2012, and, therefore, the underlying premise of the Code and the substance of the Code's Principles were also fundamentally updated. The 2020 Code has, for the first time, provided a definition of 'stewardship': 'Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'[39] The definition evidences another subtle shift in the Code's tone, with, now, a much clearer emphasis on the long-term interests of clients and beneficiaries. Whereas the aims of previous versions of the Code, outlined above, were premised on issuer-specific engagement, with an underlying assumption that issuer-specific engagement by institutional investors will improve the prospects of issuers in a manner that will benefit the ultimate beneficiaries of asset owners, the more expansive definition in the 2020 Code recognises that simple issuer-specific engagement is not the only way to exercise 'good' stewardship, and that, perhaps, issuer-specific engagement may, in some instances, be superseded by other actions that 'create long-term value for clients and beneficiaries.' The number of Principles has been extended to 12 (along with a scaled-back list of six Principles applicable to service providers), divided into four categories. The first category is entitled 'purpose and governance'[40] and urges institutional investors to ensure that their internal purpose, incentives and governance mechanisms support their stewardship responsibilities. Certain Principles now seemingly go beyond simple issuer-specific engagement, and, of note, the 2020 Code provides that signatories should 'identify and respond to market-wide and systemic risks to promote a well-functioning financial system'.[41] The second category is 'investment approach',[42] the principles of which require institutional investors to align their stewardship activities with the needs of their beneficiaries (in the case of asset owners) and clients (in the case of asset managers), and ensure that those parties acting on their behalf provide services in accordance with the stewardship approach of the underlying institutional investor. Further emphasising the broader nature of the 2020 Code, signatories are required to 'systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.'[43] Although environmental and social (ES) issues were referenced in the 2010[44] and 2012[45] versions of the Code, they were named as examples of matters on which institutional investors should intervene in relation

38 See 'Passive investment' and 'Active investment' in the section 'Will Issuer-Specific Engagement be Promoted by the 2020 Code' below.
39 2020 Code, n 2 above, 4.
40 *ibid*, Principles 1-5.
41 *ibid*, Principle 4.
42 *ibid*, Principles 6-8.
43 *ibid*, Principle 7.
44 Stewardship Code 2010, n 7 above, 7 (Guidance to Principle 4).
45 Stewardship Code 2012, n 28 above, 8 (Guidance to Principle 4).

to issuer-specific engagement, whereas, under the 2020 Code, environmental, social and governance (ESG) issues have become more pervasive in relation to investment policy (including integration into holding and exit decisions[46]). The third category is 'engagement'[47] and mirrors the issuer-specific engagement extolled by previous versions of the Code, with encouragement of institutional investors to engage with issuers, collaborate with other institutional investors, and escalate stewardship activities where necessary. The final category of 'exercising rights and responsibilities'[48] again reflects issuer-specific engagement, principally relating to the exercise of votes by institutional investors in issuers, and the policies and considerations influencing those decisions. Therefore, although issuer-specific engagement is still the central tenet to the Stewardship Code, the Code now embraces a wider, more progressive approach. How that broader scope accords with engagement will be discussed in the final part of this article.[49]

The remainder of this article focuses specifically on engagement, given that, post-Kingman Review, the standard by which the effectiveness of the 2020 Code will be judged is the extent to which it improves institutional investor engagement with issuers. In the next part of this article, the legal, regulatory, contractual and commercial duties of institutional investors to their clients and beneficiaries will be outlined, since those duties will be critical to evaluating the prospects for the 2020 Code to encourage issuer-specific, or other, engagement.

DUTIES OF INSTITUTIONAL INVESTORS

If the principal objective of the Stewardship Code is to encourage greater issuer-specific engagement, the 2020 Code could simply specify that institutional investors should proactively engage with issuers to ensure that their business strategies are conducted in a manner conducive to the long-term success of those companies. This would resonate with the Walker Review which berated investors for not engaging in a manner to improve the long-term health of issuers, and the Kay Review which bemoaned the short-termism of issuers and the capital markets in general.[50] However, instead, as discussed above,[51] the definition of 'stewardship' in the 2020 Code ties the concept of 'stewardship' to creating 'long-term value for clients and beneficiaries'.[52] Even the 2012 version of the Code, which more expressly highlighted the need to promote the long-term success of companies, also noted that stewardship should be conducted in a manner that benefits the ultimate providers of capital.[53] To understand the FRC's approach, and prior to assessing the propensity for the Code to promote issuer-specific engagement, it is apposite to briefly outline the duties that are in fact owed by institutional investors. A voluntary, soft-law code cannot ask

46 2020 Code, n 2 above, Principle 7 – Reporting Expectations: Context.
47 *ibid*, Principles 9-11.
48 *ibid*, Principle 12.
49 See 'The Broader Scope of the 2020 Code and Holistic-Risk Engagement' below.
50 Walker Review, n 5 above, 72; Kay Review, n 27 above, 14-21.
51 n 39 above, and accompanying text.
52 2020 Code, n 2 above, 4.
53 n 28 above, 1, and accompanying text.

institutional investors to take any actions which are contrary to the duties that they owe.

Institutional investors under the Stewardship Code are asset owners and asset managers.[54] Asset owners collate funds from beneficiaries with a view to investing those funds on their behalf. In turn, asset owners appoint asset managers to manage (and invest) those funds. Starting with the duties of asset managers, an asset manager will owe duties to the asset owner whose funds it is managing. It has been suggested the duty is fiduciary in nature,[55] but even absent a fiduciary duty, contractual duties (which can supersede fiduciary duties[56]) will be owed in accordance with the investment mandate specified in the asset management contract.[57] UK-based asset managers, which are the only asset managers with any regulatory compunction to sign-up to the Code,[58] must also be authorised by the Financial Conduct Authority (FCA) to provide investment management services, which entails compliance with the FCA's Conduct of Business Sourcebook (COBS).[59] COBS 2.1.1R requires such asset managers to act in the best interests of their clients (the asset owners).[60] Furthermore, in the context of the asset management of UK trust-based occupational pension schemes, an asset manager must exercise its investment management powers in the best interests of the underlying beneficiaries of the pension scheme.[61] The position in relation to the duties of asset owners is a little less certain since not all asset owners (unless they also provide asset management services[62]) are regulated by the FCA. However, with respect to pension funds, which form the vast majority of asset owner signatories to the Stewardship Code,[63] duties will be owed to beneficiaries from a legal or regulatory perspective. For trust-based pension schemes, trust law will intervene, and trustees will owe fiduciary duties to beneficiaries to act in their interests.[64] Although fiduciary duties are unlikely to apply to contractual-based pension schemes,[65] they must still be operated in the interests of their beneficiaries from a regulatory perspective - the provider of a contractual-based pension scheme must establish an independent governance committee[66] which must act

54 n 10 above, and accompanying text.
55 *Obiter dicta* by Moore-Bick LJ in *Diamantides* v *JP Morgan Chase Bank* [2005] EWCA Civ 1612 at [27]; Law Commission, *Fiduciary Duties of Investment Intermediaries: A Consultation Paper* Consultation Paper No 215 (2013) 197.
56 Law Commission (2013), *ibid*, 174.
57 I. Chiu, 'Turning Institutional Investors into "Stewards": Exploring the Meaning and Objectives of "Stewardship"' (2013) 66 *Current Legal Problems* 443, 448.,
58 n 22 above.
59 *ibid*.
60 In relation to consumers, it should be noted that the FCA is considering whether to strengthen and clarify the duties owed by regulated firms (FCA, 'A duty of care and potential alternative approaches: summary of responses and next steps' Feedback Statement FS19/2, April 2019, 18).
61 The Occupational Pension Schemes (Investment) Regulations 2005, reg 4(2).
62 In relation to 'in-house' asset management, see n 84 below, and accompanying text.
63 As of the end of 2019, of the 105 asset owners that had signed-up to the Stewardship Code, 82 of them were pension funds or amalgamations of multiple pension funds (discerned from an author analysis of FRC, 'Tiering of 2012 Stewardship Code Signatories' n 30 above).
64 A. Tilba and A. Reisberg, 'Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement' (2019) 82 MLR 456, 466-469. Even outside of the pensions realm, asset owners that constitute trust-based relationships will owe similar duties to beneficiaries.
65 Law Commission, *Fiduciary Duties of Investment Intermediaries* Law Com No 350 (2014) 159.
66 COBS 19.5.2R.

solely in the interests of policyholders.[67] Therefore, a significant proportion of the actors that are covered by the Stewardship Code are subject to legal or regulatory duties owed to clients and/or beneficiaries. Even for the handful of asset owner signatories to the Stewardship Code that are neither trust-based nor pension funds, so not subject to fiduciary or regulatory duties, for some, contractual duties will apply,[68] and for those to which such contractual duties have not been expressly delineated, from a commercial perspective, the relevant asset owners will swiftly be out of business if they do not act in the interests of beneficiaries.

With what, however, should the interests of beneficiaries and clients be equated? It seems that, in most cases, the answer will be the financial interests of those beneficiaries and clients. Taking trust-based pension funds as an example, the Law Commission clarified the nature of the fiduciary duties owed by trustees to beneficiaries, and it was confirmed that trustees could take into account considerations that are not purely financial in their nature on a permissive basis, but only to the extent that such considerations are financially material to the value of the relevant portfolio.[69] That may sound like a tautology, and, in many respects, it is, but the diktat clarified that although trustees should generally prioritise the financial interests of beneficiaries, they should also be aware that certain considerations, such as ES issues, that may not obviously be financial in nature, can have an impact on the long-term financial value of a portfolio. In relation to purely non-financial considerations, the Law Commission expressed: 'trustees should not accept a lower return from an investment simply because it will improve members' quality of life'.[70] The logic can also be extended to outside the trust-based arena, since, as discussed above, it is likely that legal, regulatory or contractual duties will also be owed by asset managers and non-trust asset owners,[71] and, by analogy, those interests will generally be envisaged to be financial in nature.[72] Additionally, with an expectation that funds will be held and managed to maximise financial returns, asset owners and asset managers will be under commercial pressure to generate valuable returns.

The Law Commission did, however, identify a specific scenario where purely non-financial issues could be prioritised over the financial interests of beneficiaries by trust-based pension schemes; this being where the trustees have good reason to believe that scheme members share the relevant concerns (so long as the decision in question does not risk significant financial detriment to the fund).[73] Therefore, taking engagement, if beneficiaries see value in widespread issuer-specific engagement (perhaps as a 'greater good'), even if such a

67 COBS 19.5.5R(1).
68 For example some investment funds, particularly if they target sophisticated investors, will contractually agree with beneficiaries to deal with funds in the interests of those beneficiaries and subject to specific investment parameters.
69 Law Commission (2013), n 55 above, 151; Law Commission (2014), n 65 above, 101.
70 Law Commission (2013), *ibid*, 157.
71 nn 55-68, and accompanying text.
72 For example large asset managers often disclose that they will support ESG-related proposals only to the extent that they are beneficial to share value or shareholder interests (C. Griffin, 'Environmental and Social Voting at Index Funds' (2020) 1, 11-14 at https://ssrn.com/abstract=3542081; S. Griffith, 'Opt-In Stewardship: Toward an Optimal Delegation on Mutual Fund Voting Authority' (2019) 1, 41 at https://ssrn.com/abstract=3404298).
73 Law Commission (2014), n 65 above, 118.

strategy will generate lesser financial returns, the trustees may make decisions based upon those preferences. Similarly, with respect to non-trust-based funds, as long as the relevant contractual mandate is clear as to the wishes of beneficiaries or clients, the relevant asset owner or asset manager will be safe in pursuing those mandates. In a nod to the Law Commission's elucidation, the 2020 Code requires disclosure as to how institutional investors have sought beneficiaries' and clients' views, and how they have taken those views into account in their investment approach.[74] However, for an institutional investor, seeking and acting upon such views is mired in peril. For an asset owner, attempting to seek the views of potentially thousands of beneficiaries is clearly impractical beyond requesting answers to broad generic questionnaires which are unlikely to collate detailed views, or be completed by all addressees.[75] In any case, it is implausible that preferences amongst beneficiaries will be clear-cut, and, in reality, certain beneficiaries may well have a preference for issuer-specific engagement, but others will covet pure financial returns and, accordingly, will desire that the asset owner (and by extension, asset manager) follows a strategy that prioritises financial value.[76] In such cases, for trust-based pensions, the Law Commission postulated that the Courts will likely expect trustees to give precedence to financial factors.[77]

The Law Commission acknowledged, however, that greater clarity exists for specialist funds where the preferences of beneficiaries could more easily be presumed.[78] ESG or socially responsible investment specialist funds, which only invest in line with ESG- or sustainability-friendly policies, have become increasingly popular in recent years,[79] and, potentially more pertinent in the context of issuer-specific engagement, 'stewardship funds' have also emerged. Specialist funds can take decisions aligned with the underlying aims of the fund, even if those decisions do not maximise the financial value of the portfolio, since the views of the beneficiaries can be presumed by their positive decision to invest in a fund exhibiting those specialist characteristics. In terms of engagement, though, the handful of aforementioned specialist 'stewardship funds'

74 2020 Code, n 2 above, Principle 6 – Reporting Expectations: 'Activity' and 'Outcome'.

75 It has been noted that index funds do not make efforts to seek beneficiaries' views (C. Griffin, 'We Three Kings: Disintermediating Voting at the Index Fund Giants' (2019) 1, 3 and 18 at https://ssrn.com/abstract=3365222). Some have suggested that a potential solution to stewardship issues would be to give beneficiaries 'pass-through' voting rights (for example J. Fisch, 'The Uncertain Stewardship Potential of Index Funds' ECGI Working Paper Series in Law No 490/2020 (2020) 101, 120-125; Griffin (2019), *ibid*, 33; Griffin (2020), n 72 above, 35). UK legislation already contemplates the implementation of such schemes (Companies Act 2006 (CA 2006), s 145), but it would entail extreme administrative issues, and one could be sceptical as to whether beneficiaries will regularly exercise those rights.

76 By analogy to ES issues, see Griffin (2019), *ibid*, 13. The propensity for retail investors to support environmental over financial considerations, for example, may be overstated (Fisch, *ibid*, 119), highlighting the uncertainties that asset owners and asset managers face in ascertaining beneficiary preference.

77 Law Commission (2014), n 65 above, 121.

78 *ibid*, 126. The Law Commission specifically referenced funds set-up by religious groups, charities or political organisations.

79 M. Lipton, 'Some Thoughts for Boards of Directors in 2018' Harvard Law School Forum on Corporate Governance, 30 November 2017; Griffin (2020), n 72 above, 15; D. Katelouzou and A. Klettner, 'Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential' (2020) 1, 14 at https://ssrn.com/abstract=3578447.

that have emerged are essentially little more than sustainability or ESG-focused investments, rather than issuer-specific engagement funds.[80] In any case, it is outside of the scope of this article to assess the levels of engagement exercised by specialist funds, which will occur, or not, outside of any encouragement under the Stewardship Code. Future research could focus on whether disclosure requirements for specialist funds should be more prescriptive than those for general funds, since the underlying investors in those funds are providing their capital on the basis that it will be employed in a specific manner disconnected from purely maximising financial returns,[81] and outside of the UK, the EU has taken up the baton in requiring, on a mandatory basis, more robust disclosures by specialist sustainability-related funds.[82]

In summary, outside of specialist funds, asset owners and asset managers will be required to, or will be under commercial pressure to, act in a manner that maximises the financial value of the relevant portfolio. Even in relation to specialist funds, beneficiaries are investing in order to make a return, and, therefore, notwithstanding a focus on investments that further the non-financial specialist interests of the fund's beneficiaries, it will be incumbent on the asset owners and asset managers of those funds to generate positive returns. Therefore, when ascertaining the propensity for institutional investors to exercise issuer-specific engagement, crucial considerations will be whether such engagement is in the financial interests of the underlying beneficiaries, and in the commercial interests of those institutional investors. It is discussed in the next section, though, that, as with the emperor's new clothes, an assumption that issuer-specific engagement will be conducive to those financial and commercial interests is the Stewardship's Code's invisible cloak.

80 For example Aviva's Stewardship Funds at https://www.aviva.co.uk/retirement/fund-centre/stewardship/; Baillie Gifford Global Stewardship Fund at https://www.bailliegifford.com/en/uk/institutional-investor/funds/global-stewardship-fund/.

81 Of particular note, US research has levied scepticism that specialist ESG-funds operate any differently from generalist funds, particularly when managed by the same asset manager, with it being found that ESG-funds often fail to vote in accordance with sustainability goals (Griffin (2019), n 75 above, 13), and, in relation to the large asset managers, ESG-specialist funds usually vote in line with other generalist funds managed by the same asset manager (L. Strine, 'Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System' (2017) 126 YLJ 1870, 1914; Griffin (2020), n 72 above, 25). They are also often opaque and misleading as to how ESG-issues manifest themselves in investment, engagement and voting decisions (Griffin (2020), *ibid*, 15, 30 and 32).

82 The EU has published regulations which require certain 'financial market participants' to disclose specific information about products which promote ES-characteristics or which have objectives related to positive impacts on the environment and society (Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, Arts 8-11), mainly applicable in Member States from 10 March 2021 (*ibid*, Art 20). 'Financial market participants' are, broadly, asset managers, insurance companies and occupational pension schemes (*ibid*, Art 2). Required disclosures include full details of the relevant characteristics or objectives, information on any benchmarks used, how characteristics or objectives are met (to the extent no benchmarks are used), and the methodologies used to assess and measure performance against the relevant characteristics or objectives.

WILL ISSUER-SPECIFIC ENGAGEMENT BE PROMOTED BY THE 2020 CODE

Having established that asset owners and asset managers will generally, as a matter of legal, regulatory or contractual duties, or as a matter of commercial practicality, act in the financial interests of beneficiaries and clients, respectively, in this section, it will be discussed whether acting in those interests will manifest itself in the issuer-specific engagement as advocated by the Walker and Kingman Reviews, and as encouraged by the 2020 Code. In particular, any urgings by a code that is applied on a soft-law basis to engage with companies will not be heeded if such actions clash with the relevant duties owed,[83] and, therefore, if issuer-specific engagement is contrary to those duties, the 2020 Code may have already lost before it has even played the game.

Asset owners either conduct investment management directly (in which case 'asset management' functions are performed in-house) or delegate the functions to asset managers. Therefore, in terms of engagement, asset management is critical, since engagement with issuers will be conducted by internal or external asset managers.[84] An asset owner acting in the interests of its beneficiaries, will be concerned to ensure that the asset manager it employs (internally or externally) conducts itself in a manner that will ultimately be in the interests of the asset owner's beneficiaries. Therefore, it is imperative to assess the strategies of asset managers, and whether issuer-specific engagement can be incorporated into those strategies in the interests of beneficiaries. There are three main asset management strategies to be considered – passive investment, active investment and offensive activist investment.

Passive investment

The definition of 'passive investment' can vary, but, in broad terms, a fund is usually deemed to be pursuing a passive investment strategy if it holds a well-diversified portfolio, does not engage in extensive buy-and-sell activity, and closely tracks an index.[85] So-called 'index trackers' seek to replicate the performance of a market index, such as the FTSE-350,[86] by investing only in the constituents of the relevant index on a weighted basis. Stock is only bought-and-sold upon shifts within the index when the index itself reconstitutes.[87]

83 Tilba and Reisberg (2019), n 64 above, 485-486.

84 In 2017, 92 and 88 per cent of asset owners outsourced engagement and voting, respectively (The Investment Association, and Pensions and Lifetime Savings Association, *Stewardship in Practice 2016* (London: The Investment Association, 2017) 5). A small proportion of asset managers also outsource engagement and voting (six and 13 per cent, respectively) (*ibid*, 5), hence the additional focus on service providers in the 2020 Code.

85 K. James *et al*, 'Does the growth of passive investing affect equity market performance?: A literature review' (2019) FCA Research Note 1, 4.

86 An index ranks listed companies on various measures of performance. The FTSE-350 is an index maintained by a subsidiary of the London Stock Exchange comprising the 350 largest premium-listed companies by market capitalisation.

87 The constituents of the FTSE-350, for example, are reviewed on a quarterly basis (FTSE Russell, 'FTSE 350 Index: Factsheet' 31 March 2020).

With no discretionary buy-and-sell decisions being made, research costs, and therefore fees, are low, and, accordingly, beneficiaries are provided with an economical option with which to share in the performance of a specific index of stock.[88] Passive investments form an increasing proportion of UK-equity ownership.[89]

Although on the face of it passive funds have the most to gain by issuer-specific engagement, since they do not have the option of exiting the relevant investment for so long as the issuer is a constituent of the index that the fund tracks,[90] the reality is very different. The academic literature has regularly noted the conundrum for asset managers that pursue a passive investment strategy. Firstly, passive funds slavishly track an index, and their products are sold on the proposition that returns will accurately correlate with the performance of the index.[91] An index-tracker will have little concern that a poorly performing company within the index could reduce the overall value of the portfolio, since it will not impact the capacity of the index-tracker to satisfy its remit to track the index accurately. Second, since an index-tracker fund does not make calculated decisions as to whether to invest in individual equities, with the decisions driven purely by index-inclusion, there is no prerequisite to allocate resources to issuer-specific research expertise which would otherwise inform investment decisions.[92] Without such expertise, it becomes difficult for passive investors to identify engagement opportunities. Third, passive funds will have highly diversified portfolios of hundreds or even thousands of issuers, with relatively small investments in individual companies; therefore, an engagement with an individual issuer will, even if successful, have only a very small impact on portfolio value.[93] In many cases, the costs of the engagement will outweigh the benefits to the portfolio, and, therefore, the relevant engagement, although potentially in the best interests of the issuer, will not be in the best interests of the asset manager's client[94] (with a caveat that for the largest asset managers, such institutions will manage the assets of numerous asset owner portfolios, and, potentially, the relevant costs could be shared between all those portfolios[95]). Finally, and

88 Fisch, n 75 above, 110; G. Strampelli, 'Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing' (2018) 55 San Diego L Rev 803, 809.

89 In 2018, passive funds accounted for approximately 26 per cent of all UK assets under management (rising from only 16 per cent in 2008), and 42 per cent of UK-managed equity assets were managed passively (The Investment Association, 'Asset Management in the UK 2018-2019: The Investment Association Annual Survey' September 2019, 45).

90 J. Fisch, A. Hamdani and S. Davidoff Solomon, 'The New Titans of Wall Street: A Theoretical Framework for Passive Investors' (2019) 168 U Pa L Rev 17, 37; I.R. Appel, T.A. Gormley and D.B. Keim, 'Passive investors, not passive owners' (2016) 121 J Financ Econ 111, 113.

91 Fisch, n 75 above, 110; V. Sushko and G. Turner, 'The implications of passive investing for securities markets' (2018) *BIS Quarterly Review* 113, 119.

92 *ibid*; Davies, n 20 above, 14.

93 R. Gilson and J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113 CLR 863, 891; L. Bebchuk, A. Cohen and S. Hirst, 'The Agency Problems of Institutional Investors' (2017) 31 J Econ Perspect 89, 96.

94 L. Bebchuk and S. Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (2019) 119 CLR 2029, 2051.

95 W. Ringe, 'Stewardship and Shareholder Engagement in Germany' ECGI Working Paper No 501/2020 (2020) 1, 11. On the other hand, large asset managers may be ill-suited to take advantage of such economies of scale in relation to issuer-specific engagement (as opposed to

importantly, a successful intervention by a passive asset manager will equally benefit all of its competitors that passively track the same index, but only the asset manager who intervenes will bear the costs of the engagement.[96] The portfolio managed by the intervening asset manager will generate less returns for asset owners than competitors after the costs of engagement have been deducted from profits, or charged as fees. Those accrued engagement costs can therefore also impact the perceived performance of the intervening passive asset manager (and underlying asset owner) if it is assessed on the margin of its index-tracking errors relative to errors made by other passive asset managers.[97] Even though a successful issuer-specific engagement could be deemed to be in the best interests of beneficiaries overall by creating value, if an asset owner has a choice of multiple asset managers tracking the same index, it would be in the interests of its beneficiaries to select an asset manager not so engaging and free-ride on the efforts of an engaging asset manager.[98] This creates a predicament for asset managers – if it is not in the interests of beneficiaries for asset owners to select intervening asset managers, commercial incentives will dictate that those asset managers do not engage on issuer-specific matters,[99] even if they are overall wealth-maximising for clients. Although successful engagement can increase the fees payable to the asset manager,[100] if asset owners, acting in the interests of their beneficiaries, reject that asset manager in favour of non-intervening asset managers, the asset manager will soon cease to attract clients. The Stewardship Code has essentially attempted to supersede the commercial incentive aspects – the aspiration is that by requiring signatories to disclose their commitment to engagement, a market for engagement will be created whereunder beneficiaries, seeing the 'greater good', will select asset owners based upon their proclivity to select asset managers with substantive engagement strategies, leading to all asset

holistic-risk engagement described later in this article), due to conflicts of interest between different, not necessarily equity-investment, funds being managed (J. Morley, 'Too Big to be Activist' (2019) 92 S Cal L Rev 1407). Financial- or business-ties between large asset managers and issuers may also create conflicts to engagement (Bebchuk and Hirst, *ibid*, 2062).

96 Gilson and Gordon, n 93 above, 894; Bebchuk and Hirst, *ibid*, 2057; Davies, n 20 above, 16; M. Isaksson and S. Çelik, 'Who Cares? Corporate Governance in Today's Equity Markets' OECD Corporate Governance Working Papers No 8 (2013) 1, 42; S. Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 HLR 1735, 1753; Bebchuk, Cohen and Hirst, n 93 above, 98.

97 C. Rawson and S. Rowe, 'Disengaged Owners and Financial Reporting: Evidence form the index funds' 1, 8 (2019) at https://ssrn.com/abstract=3459513. Some commentators have also remarked that when asset managers are assessed on the basis of relative performance, taking such asset managers across the industry as a whole, it can create agency costs for underlying beneficiaries, since the interests of asset managers in maximising relative performance may not be aligned with the interests of beneficiaries in maximising overall returns (Gilson and Gordon, *ibid*, 889-890). However, when taking passive asset managers on an individual basis, as discussed in this article (see text accompanying n 98 below), the interests of beneficiaries are best served by an asset owner selecting an asset manager that does not undertake issuer-specific engagement, and, instead, free-rides upon the efforts of others.

98 Bebchuk, Cohen and Hirst, n 93 above, 98; Strampelli, n 88 above, 815.

99 Gilson and Gordon, n 93 above, 890. For practical evidence of the passivity of passive investors, see B. Cheffins, *The Public Company Transformed* (Oxford: OUP, 2019) 378-379.

100 Most passive fund fees are based upon a percentage of assets under management (AUM). If the engagement creates value that exceeds the costs of the engagement, AUM, and, correspondingly, the asset manager's fees, increase.

managers commercially pursuing such engagement strategies. Such a market has not materialised.[101] This brings into stark light the flaws in a voluntary soft-law code – where only some, and not all, index-tracker asset managers engage, it will consistently be in the best interests of beneficiaries for asset owners to select non-engaging asset managers.

Active investment

Although passive investment is becoming increasingly prevalent in the UK-equity markets, the majority of asset management is conducted on an active basis. A genuinely active asset manager will not track a particular index, and will, instead, continually make buy-and-hold decisions, for its clients, across the market based upon its determination of how best to improve portfolio value.[102] For most active investors, similar considerations, to those which are relevant to passive funds, will apply, since many will, with a view to reducing risk, pursue a diversified investment policy,[103] and, therefore, will elect for asset managers that can collate a diversified portfolio of numerous equities across multiple industries[104] (passive index-tracking is the ultimate low-cost manifestation of such preferences). With only a relatively small proportion of a portfolio's shares held in individual issuers, again, the costs of engagement may outweigh the benefits.[105] Also, competitors invested in the same issuers will share in the success of the intervention without suffering the costs,[106] which will be concerning for those active asset managers that are assessed by asset owners on the basis of relative performance[107] – the investment mandate is likely to require at least a

101 Chiu and Katelouzou, n 20 above, 150. If a market for 'stewardship' more generally exists, it is currently very small (D. Katelouzou and E. Micheler, 'The Market for Stewardship and the Role of Government' (2020) 1, 10-17 at https://ssrn.com/abstract=3704258). Although, in the US, commentators have suggested that voluntary stewardship disclosures evidence the existence of a market for stewardship (A. Hamdani and S. Hannes, 'The Future of Shareholder Activism' (2019) 99 B U L Rev 971, 982), most of such disclosures do not relate to issuer-specific engagements beyond governance issues (for example see n 179 below), or holistic-risk issues discussed further below (text accompanying nn 179-180 below). Furthermore, investors may not have the expertise to evaluate stewardship credentials (Bebchuk and Hirst, n 94 above, 2073).

102 It should be noted that certain active asset managers, sometimes referred to as 'closet indexers' (S. Hirst and K. Kastiel, 'Corporate Governance by Index Exclusion' (2019) 99 B U L Rev 1229, 1250), will mimic a passive strategy, since, for example, fund managers may invest a significant portion of assets under management in the indices to hedge risk if the performance of such fund managers is being assessed against the performance of indices (B. Cheffins, 'The Undermining of UK Corporate Governance (?)' (2013) 33 OJLS 503, 513; Hirst and Kastiel, *ibid*, 1256), in which case the same concerns as described above in relation to passive funds will still apply.

103 Arsalido, n 11 above, 363.

104 The classic study on portfolio selection by Markowitz outlined that for an investor trying to garner returns, but reduce risk, diversification is the natural strategy (H. Markowitz, 'Portfolio Selection' (1959) 7 J Financ 77, 89 and 91).

105 Gilson and Gordon, n 93 above, 891; Chiu, n 57 above, 461; Reisberg, n 11 above, 233. See n 95 above, and accompanying text in relation to the potential for cost-sharing by large asset managers.

106 Gilson and Gordon, *ibid*, 893; Arsalidou, n 11 above, 364; Bebchuk, Cohen and Hirst, n 93 above, 99.

107 Asset managers may, alternatively, be assessed on overall portfolio performance, but this is more usual when mandated to invest in a broad range of different assets. In such cases, the focus will be

minimum outperformance of unmanaged (passive) portfolios,[108] and, commercially, active asset managers will also be evaluated against each other.

One scenario where it may be in the interests of clients and beneficiaries (and, by extension, an asset manager in commercial terms) to exercise issuer-specific engagement would be where the portfolio is substantially 'overweight' in an issuer.[109] In simple terms, an investor will be overweight in an issuer if the proportion of the portfolio invested in the issuer is greater than the proportion that it owns of the market generally.[110] If the asset manager has invested a substantially greater proportion of the portfolio in the issuer as compared to competitor active asset managers, and the issuer performs poorly, the portfolio will be disproportionately impaired, and, as a corollary, successful engagement will garner greater returns for the engaging asset manager than competitors.[111] However, having become overweight in an issuer's stock, issuer-specific engagement will be predisposed upon the asset manager initially expending resources on detailed analysis of the relevant company to ascertain whether there is an issue on which it could engage to increase share value, and, subsequently, having identified the issue, on actually engaging with management and lobbying for change. The benefits of taking both the initial and subsequent actions are highly uncertain, since they will only create value if three conditions are fulfilled - the initial analysis identifies an issue, the subsequent engagement is successful in instigating change, and the change results in greater long-term value for the issuer. The level of uncertainty could deter the asset manager from expending resources in identifying issues in the first place, and, even if the asset manager were to identify an issue, the high uncertainty of the other two conditions will likely make a decision to sell the stock (or at least to sell sufficient stock so that the investor is no longer overweight) more rational than engaging.[112] In particular, if the third condition is not satisfied, it is possible that the engagement could even result in a negative impact on the issuer's performance, in which case the asset manager suffers even greater damage as compared to its competitors due to being overweight in the relevant stock.[113] Overall, with great uncertainty of success, except in the most obvious cases of mismanagement at issuers, it will rarely be in the best interests of clients and beneficiaries for an asset manager to regularly expend costs in speculative research and engagement.

on allocation effectiveness, and the noise of individual stock performance will be drowned out by overall equities performance compared to other assets in the portfolio (Gilson and Gordon, *ibid*, 894).

108 A.R. Admati, P. Pfleiderer and J. Zechner, 'Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium' (1994) 102 J Political Econ 1097, 1100. Such 'benchmarking' can, as with passive asset managers (n 97 above), lead to the interests of asset managers deviating from the interests of beneficiaries (Gilson and Gordon, *ibid*, 889-890 and 893).

109 P. Frentrop, 'The Engaged Investor: The paradoxes of stewardship' *IPE Magazine* February 2011; B. Black and J. Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92 Mich L Rev 1997, 2070.

110 Black and Coffee, *ibid*, 2048.

111 Bebchuk, Cohen and Hirst, n 93 above, 99.

112 Gilson and Gordon, n 93 above, 893. Exit was the determination of many institutional investors in banks prior to the 2008 financial crisis (A. Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 36 Seattle U L Rev 639, 651-652).

113 Notably, the empirical evidence on whether shareholder engagement is conducive to firm value is inconclusive (n 120 below).

If the discussion above paints a pessimistic picture in terms of issuer-specific engagement, it should not be taken to mean that passive and active institutional investors do not engage at all. Indeed, in terms of voting, institutional investors have progressively become more participatory over the years.[114] If a resolution is put up for a vote by issuer management, institutional investors will generally vote their shares. Institutional investors may also engage with issuer boards in relation to those matters prior to the vote; particularly on executive remuneration[115] or governance matters.[116] However, concerns exist that institutional investors are merely box-ticking against industry norms,[117] or relying on proxy advisors who, in turn, have been accused of box-ticking themselves, rather than truly considering whether the relevant governance or pay arrangements are appropriate for the issuer in question.[118] As above, significant expenditure on relevant analysis by passive or active funds is unlikely. Intervention on the basis of inadequate expertise, research and analysis could negatively impact issuer share value,[119] which perhaps explains why the evidence on whether shareholder engagement of this nature improves issuer share value is inconclusive.[120] The low-costs involved make engagement on tick-box governance issues the engagement of choice for 'defensive' institutional investors,[121] rather than proactive intervention on performance and strategic matters,[122] and, therefore, continuing to

114 See Black and Coffee, n 109 above, 2038. In 2019, the FTSE-100 and FTSE-250 average voting levels were 75 and 77 per cent, respectively (KPMG and Makinson Cowell, 'Review of the 2019 AGM season' January 2020). Also see S. Gomtsian, 'Shareholder Engagement by Large Institutional Investors' (2019) 1, 31 JCL forthcoming at https://ssrn.com/abstract=3412886; Fisch, Hamdani and Davidoff Solomon, n 90 above, 43-47; Gilson and Gordon, n 93 above, 887.

115 F. Ferri and D. Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 Rev Financ 527, 546; R. Thomas and C. Van der Elst, 'Say on Pay Around the World' (2015) 92 Wash U L Rev 653, 730; CIPD Research report, 'Executive pay: Review of FTSE 100 executive pay packages' August 2017, 2; KPMG Board Leadership Centre, 'Guide to Directors' Remuneration 2017' (December 2017) at 11.

116 Appel, Gormley and Keim (2016), n 90 above, 124-126; Davies, n 20 above, 13-14.

117 The UK CGC outlines 'best practice' for premium-listed companies. Various bodies also publish executive pay expectations and recommendations (for example Investment Association, 'Principles of Remuneration' (2019)).

118 Reddy, n 35 above, 698-703.

119 Fisch, n 75 above, 114; N. Boyson and R. Mooradian, 'Corporate governance and hedge fund activism' (2011) 14 Rev Deriv Res 169, 171; D. Lund, 'The Case Against Passive Shareholder Voting' (2018) 43 J Corp L 493, 513; D. Lund, 'Nonvoting Shares and Efficient Corporate Governance' (2019) 71 Stan L Rev 687, 726. In the paper, Z. Goshen and R. Squire, 'Principal Costs: A Theory for Corporate Law and Governance' (2017) 117 Colum L Rev 767, it was noted that 'principal costs' could be incurred by giving shareholders extensive powers to intervene when they are uninformed or inexperienced to do so.

120 For a discussion on the empirical evidence, see R. Romano, 'Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance' (2001) 18 Yale J Regul 174, 187-191; S. Gillan and L. Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 J App Corp Fin 55, 61-62; J. Karpoff, 'The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings' (2001) 1, 19 at https://ssrn.com/abstract=885365. In contrast, there is some limited UK evidence of a positive correlation between engagement and issuer operating performance (M. Becht et al, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2009) 22 Rev Financ Stud 3094, 3118).

121 For the difference between defensive and offensive institutional investors, see nn 132-133 below, and accompanying text.

122 n 128 below, and accompanying text; n 179. Also see Bebchuk and Hirst, n 94 above, 2090; Gilson and Gordon, n 93 above 889; Gomtsian, n 114 above; L. Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 HLR 833, 876; Strampelli, n 88 above, 823-825.

encourage issuer-specific engagement will likely only heighten box-ticking engagement on governance matters that could, in fact, have no effect, or even a detrimental effect, on issuers. Even though the Stewardship Code originally envisaged that the UK CGC and the Stewardship Code would operate hand-in-glove, such that the Stewardship Code would encourage institutional investors to engage on matters based upon governance disclosures made by issuers under the UK CGC,[123] merely intervening on governance matters does not accord with the urgings of Walker, Kay or Kingman, and the engagement that Walker and Kay, in particular, had in mind was a utopia where investors continually monitored issuer strategy to proactively determine problems and intervene before they became serious.[124] Notably, The Royal Bank of Scotland plc (RBS), which significantly suffered during the financial crisis, was in compliance with all but one of the provisions of the UK CGC.[125]

The Kay Review was conscious that the costs of adequately detailed research and engagement could deter successful and value-enhancing intervention, and suggested that a forum of like-minded asset managers be constituted so that costs could be shared, and influence enhanced through scale,[126] leading to the creation of 'The Investor Forum'. In its first five years of existence, though, the Investor Forum has only conducted 32 issuer engagements,[127] and, in 2019, it only conducted engagements with six companies, most of which related to governance and board succession issues.[128] The few strategic interventions were generally broad in nature rather than pertaining to specific issues that required resolution.[129] Even when costs of engagement are shared, it is unlikely that individual asset managers will raise engagement propositions within the Investor Forum for fear of tipping-off competitors who may exit the investment, causing a decline in share price,[130] meaning that issuer-specific strategic engagement by the Investor Forum would have to operate on the basis of collaborative research across multiple companies, which is deterred due to the high costs involved to adequately reduce the uncertainties surrounding the success of engagements. The resulting broad nature of engagements, when they do occur, is a rational consequence of such dynamics.

Beyond reactionary voting on governance matters, scope for successful proactive issuer-specific engagement will only transpire if the uncertainties surrounding engagement can be minimised. Furthermore, encouraging issuer-specific engagement on strategic aspects, when resources are not expended by institutional investors to adequately inform themselves prior to engagement, could even result in detrimental effects on issuer share value. The uncertainties that deter successful engagement could be moderated, though, if the relevant

123 Stewardship Code 2010, n 7 above, 1; H. Birkmose and M. Madsen, 'The Danish Stewardship Code – The past, the present and the future' (2020) 1 at https://ssrn.com/abstract=3533834.
124 Walker Review, n 5 above, 78; Kay Review, n 27 above, 45; Stewardship Code 2012, n 28 above, 1; BIS Committee, n 11 above, 36; Davies, n 20 above, 13-14.
125 RBS Annual Report and Accounts 2007, 99.
126 Kay Review, n 27 above, 50.
127 The Investor Forum, 'Annual Review 2019' (London: The Investor Forum CIC, 2019) 8.
128 *ibid*, 17-22.
129 As an exception, see n 140 below.
130 The 'Race to the Exit' scenario - Black and Coffee, n 109 above, 2061-2062.

investor eschews a diversified portfolio strategy in favour of larger investments in a small number of issuers, and conducts significant analysis to identify potential share-value maximising engagements *prior* to investing in the relevant issuer. In fact, it has been modelled that, from a risk-exposure perspective, it is unlikely that an investor will become so overweight in an issuer to the extent that the benefits of engagement outweigh the costs, unless an investor has committed to engagement prior to investment.[131] Such 'offensive activism' may be the primary avenue of substantive issuer-specific engagement.

Offensive activism

'Defensive' and 'offensive' activism can be distinguished. Defensive activism occurs where an investor already has an interest in an issuer and identifies weaknesses or risks within the company. The investor then engages on an issuer-specific basis to rectify those issues to increase the long-term value of the investment.[132] As noted above, defensive activism is not likely to be prevalent beyond mere governance-related matters. Offensive activism, on the other hand, involves an investor, or potential investor, identifying an issuer where a change of strategy could result in greater shareholder returns, and subsequently acquiring shares prior to engagement in order to maximise the investor's share of the potential gains post-engagement.[133]

Offensive activism is a beloved strategy of hedge funds,[134] but they rarely acquire sufficient shares in any issuer to be able to instigate change by exercise of their voting power,[135] and, therefore, to persuade an issuer's board to change its strategic course, the hedge fund will require the support of other institutional investors, or at least the perceived support of those investors.[136] In the US, institutional investors will readily support hedge fund offensive activist campaigns.[137] Although, the tendency of institutional investors in the UK

131 Admati, Pfleiderer and Zechner, n 108 above, 1101.

132 Chiu and Katelouzou, n 20 above, 137; B. Cheffins and J. Armour, 'The Past, Present, and Future of Shareholder Activism by Hedge Funds' (2011) 37 J Corp L 51, 56.

133 Cheffins and Armour, *ibid*, 56; Bebchuk, Cohen and Hirst, n 93 above, 105; E. Rock, 'Institutional Investors in Corporate Governance' in J. Gordon and W. Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford: OUP, 2018) 382.

134 Cheffins and Armour, *ibid*, 56.

135 For companies incorporated in England and Wales, at least a majority of votes exercised at a shareholders' meeting is required to pass shareholders' ordinary resolutions (CA 2006, ss 281-282), and, generally, shareholders must hold at least five per cent of the votes in the company to call a general meeting of shareholders (CA 2006, s 303), or require a resolution to be placed on the agenda of the annual general meeting of a public company (CA 2006, s 338). Additionally, 100 members with voting rights, holding on average £100 of the paid-up capital per member, can also propose resolutions at the annual general meeting (CA 2006, s 338).

136 W. Bratton and M. Wachter, 'The Case Against Shareholder Empowerment' (2010) 158 Uni Penn L Rev 653, 684; Gilson and Gordon, n 93 above, 897; Bebchuk, Cohen and Hirst, n 93 above, 106. Also see LexisNexis, 'Market Tracker Trend Report" Recent trends in UK Shareholder activism' (2020) 1, 34 and 37. The term 'rationally reticent' has been used to describe how US institutional investors will not proactively engage with issuers, but will engage in response to proposals and engagement campaigns commenced by others (Gilson and Gordon, *ibid*, 867).

137 I.R. Appel, T.A. Gormley and D.B. Keim, 'Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism' (2019) 32 Rev Fin Stud 2720, 2760; Hamdani and Hannes, n 101

to support hedge fund campaigns has traditionally been much lower,[138] offensive activism has been rising in the UK in the years following the resurrection of the credit markets after the 2008 financial crisis.[139] Offensive activism can awaken conventionally defensive institutional investors, including passive funds, to act, and engage with issuer boards with a view to instigating the changes being requested by the hedge fund.[140] The commercial, competitive and financial deterrents to passive and active asset manager issuer-specific engagement outlined above are mitigated, since the research and analysis heavy-lifting has been completed by the hedge fund, which must present sufficient due diligence to induce institutional investors to support the campaign.[141] Even though any gains from the campaign will accrue to all institutional investors invested in the issuer, since the costs are low (and likely to also be incurred by competitor asset managers), engagement by those institutional investors can (if the relevant proposal is successful and value-enhancing) be in the best interests of clients and beneficiaries, creating increases in the absolute value of the relevant portfolio without expending disproportionate costs compared to other asset managers.[142] Additionally, in the US, it appears that the very threat of offensive activism has created a dynamic whereby issuer boards will pre-empt potential hedge fund intervention, and, therefore, proactively engage with existing institutional investors to improve performance.[143] Indirectly, offensive activism could be encouraging institutional investor engagement even where a hedge fund has not commenced a campaign.

The Stewardship Code's influence on offensive activism is, though, negligible. Hedge funds pursue an offensive activist approach as part of a clearly defined commercial strategy, and will do so whether or not the Stewardship Code encourages engagement.[144] Therefore, if at least one type of investor is engaging in proactive, rather than reactionary, activism as apparently extolled by Walker, Kingman *et al*, and those investors are also drawing other institutional investors into engagement, one may argue that shareholder engagement is vibrant and

above, 978-979; B. Cheffins, 'The Team Production Model as a Paradigm' (2015) 38 Seattle U L Rev 397, 730; Strampelli, n 88 above, 829; Cheffins and Armour, n 132 above, 87.

138 A recent example of institutional investors declining *en masse* to support an activist proposal was when Sherborne Investors failed to gain a board seat at Barclays plc in 2019 (LexisNexis, n 136 above, 31).

139 Activist Insight and Skadden, 'Activist Investing in Europe 2019' (2019) at 7; LexisNexis, *ibid*, 11 (although, note that a drop in the prevalence of activist campaigns in the first half of 2020 can be attributed to the COVID-19 pandemic of 2020).

140 As an example, in 2019, the Investor Forum intervened at First Group plc in response to activist proposals (Investor Forum, n 127 above, 17).

141 Gilson and Gordon, n 93 above, 896; Davies, n 20 above, 13. By analogy, it has been argued that US institutional investors will enforce against corporate wrongs and fraud at issuers where the heavy-lifting has been undertaken by journalists, regulators, whistleblowers and entrepreneurial lawyers (A. Platt, 'Index Fund Enforcement' (2019) 1, 29 at https://ssrn.com/abstract=3430643).

142 Anecdotal evidence suggests that defensive institutional investors may even solicit offensive activist investors to research and investigate issuer-specific matters (Hamdani and Hannes, n 101 above, 989; Lund (2018), n 119 above, 505).

143 Hamdani and Hannes, *ibid*, 984. In relation to issuers implementing commonly requested activist measures prior to the commencement of activist campaigns, see N. Gantchev, O. Gredil and C. Jotikasthira, 'Governance Under the Gun: Spillover Effects of Hedge Fund Activism' (2019) 23 RF 1031.

144 Davies, n 20 above, 20.

the need for the Stewardship Code is overstated. However, it is unlikely that this style of activism is the type of engagement that is desired by the FRC. Walker, in fact, decried the impact of offensive activism, railing against the short-term connotations, such as increased dividends, share buy-backs, and putting issuers up for sale.[145] Although several studies have challenged the propensity for hedge fund activism to only create short-term profits at the expense of the long-term health of issuers,[146] many commentators have derided hedge fund activism as targeting companies from which short-term value can be extracted, without any consideration for how the company will perform in the long-term.[147] Furthermore, hedge fund activists have been accused of being offensive in nature as well as strategy, employing aggressive techniques to achieve their ends.[148] Such behaviour conflicts with the concept of constructive engagement encouraged by the Stewardship Code.[149]

Given that offensive activists appear to be the only institutional investors who are motivated and incentivised to engage on issuer-specific matters, and the only institutional investors for whom it will regularly be in the interests of their beneficiaries to engage, it could be argued that the Stewardship Code should embrace such institutional investors and cajole them into behaving as originally envisaged by the Code.[150] Persuasion of such a nature would require the delineation of comply-or-explain best practice recommendations to advocate for more constructive, rather than antagonistic, engagement, with a view to long-term, rather than short-term, issuer profitability. However, the FRC rejected the 'best practice' approach in the 2020 Code,[151] and, in any case, even with such an approach, it is difficult to see how the conduct of hedge funds, if they could be compelled to sign-up to the Stewardship Code, would be meaningfully transformed by soft-law disclosure – investors in hedge funds are usually large institutional asset owners (such as pension funds) and high net-worth individuals, which are sufficiently sophisticated to apprehend the strategy and approach taken by most hedge funds.[152] Even with the reputation of hedge funds to pri-

145 Walker Review, n 5 above, 78.

146 Boyson and Mooradian, n 119 above, 193; D. Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7 Va L & Bus Rev 459; L. Bebchuk, A. Brav and W. Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 CLR 1085, 1127.

147 J. Coffee and D. Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1 Annal Corp Gov 1, 59-62; Kay Review, n 27 above, 37; Strine, n 81 above; S. Denning, 'The Seven Deadly Sins Of Activist Hedge Funds' *Forbes* 15 February 2015 at https://www.forbes.com/sites/stevedenning/2015/02/15/the-seven-deadly-sins-of-activist-hedge-funds/.

148 J. Wieczner, 'Inside Elliott Management: How Paul Singer's Hedge Fund Always Wins' *Fortune* 7 December 2017 at https://fortune.com/2017/12/07/elliott-management-hedge-fund-paul-singer/.

149 The Stewardship Code has long advocated 'purposeful dialogue' (Stewardship Code 2010, n 7 above, 1; Stewardship Code 2012, n 28 above, 1 and principle 1).

150 Some commentators have suggested that engagement by institutional investors as a whole can be enhanced by creating a more conducive environment for offensive activism (Gilson and Gordon, n 93 above, 902-916).

151 nn 33-37 above, and accompanying text.

152 K. Amadeo, 'Hedge Fund Investors: Who They Are and Why They Do It' *The Balance* 25 June 2019 at https://www.thebalance.com/who-invests-in-hedge-funds-and-why-3306239. It is likely that, for most hedge funds, marketing to unsophisticated UK retail investors will not be permitted (FSMA 2000, s 238; COBS 4.12).

oritise short-term profits, they presumably believe investment in hedge funds to be in their, and their beneficiaries', best interests. Like a bad Bond villain,[153] if hedge funds were required to disclose against best practice provisions espousing long-termism and constructive engagement, they would simply openly disclose their potentially contradictory approaches before putting them into operation. In such circumstances, it is difficult to see how behaviour would be modified – investors know how hedge funds act, whether they are required to disclose or not.

Putting issuer-specific engagement into context

Well-informed issuer-specific engagement on strategic matters, prompted by defensive activists, will rarely be the preferred option for asset managers, whether active or passive, and no manner of voluntary soft-law encouragement will influence them to do otherwise. As such, the 2020 Code will not enhance the traditional form of issuer-specific engagement as espoused by the Walker Review, and, if the Kingman Review has put the Code on final notice, it is on borrowed time. On the contrary, the danger exists that further pressure, pursuant to the 2020 Code, on institutional investors to exercise issuer-specific engagement will simply increase governance, uninformed or superficial engagements, which do not necessarily improve the performance of issuers. However, if the regulators were to be given one further chance, all may not be lost when it comes to issuer-specific engagement. Institutional investor involvement in issuer-specific strategic matters is promoted by the actions of offensive activists,[154] and, therefore, the focus should turn to how and when other institutional investors support offensive activist campaigns.[155] In those specific cases, disclosure by asset managers of engagement strategy when presented with offensive activist proposals, and by asset owners of the engagement strategy sought when selecting asset managers, and how those strategies conform to the investment horizons of beneficiaries, could be useful information for both clients and beneficiaries. Some have speculated that the increasing prevalence of passive investors, with longer-term considerations than traditional hedge firms, will influence hedge firm activist campaigns to focus on longer-term issues, rather than short-term value orientated proposals, to garner support from those passive investors.[156] In such cases, disclosure by defensive activists as to when they will support offensive activism would be conducive to a longer-term focus by hedge funds. Of course, the foregoing supposition assumes that defensive activists will only support offensive activist campaigns that create long-term

153 I. Fleming, *Casino Royale* (London: Jonathan Cape, 1953).

154 M. Kahan and E. Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 U Penn L Rev 1021, 1045; Strampelli, n 88 above, 826. Also see n 141 above, and accompanying text.

155 Even passive investors can be pivotal voters when offensive activists make issuer-specific proposals (Fisch, Hamdani and Davidoff Solomon, n 90 above, 42).

156 Appel, Gormley and Keim (2019), n 137 above, 2760; Strampelli, n 88 above, 830; Lund (2018), n 119 above, 505; S. Alvaro, M. Maugeri and G. Strampelli, 'Institutional investors, corporate governance and stewardship codes' (2019) 1, 44 at https://ssrn.com/abstract=3393780.

value, and the need for more robust disclosure is emphasised by suggestions by other commentators that such investors may not always tailor their support for offensive activist campaigns in line with the optimal interests of issuers.[157] Although the 2020 Code, like previous versions of the Code, does urge participation in collaborative engagement, and now also urges disclosure of activities and outcomes in relation thereto,[158] the relevant Principle was never intended to pertain to the possible support of hedge fund activism. Instead, it relates to collaborative engagement between defensive institutional investors in a manner that enables them to engage on issuer-specific matters at scale. In fact, the engagement that does occur is primarily by offensive activists, with the traditional defensive activists, which make up the signatories to the Code, either supporting or rejecting the offensive activist proposal. It is therefore sometimes not even 'engagement' *per se* by the defensive activists. Accordingly, if the FRC wishes to persist with a Code with issuer-specific engagement as a principal theme, it should acknowledge offensive activist engagement as the primary instigator of stewardship action by signatories, rather than attempting to encourage a style of traditional issuer-specific engagement by defensive institutional investors that is doomed to failure. The Code should specifically reference the need for asset owners and asset managers to set-out exactly how and in what circumstances they will support, and engage with issuers in response to, activist campaigns,[159] to give beneficiaries (and activists) valuable information which can, subsequently, be assessed against actual decision-making. Although these disclosure requirements would be buttressed by disclosing examples of activities and outcomes, ironically, given Kingman's exhortation to focus less on policy and more on outcomes, disclosure of the policy in this regard may be a more useful disclosure for beneficiaries.[160]

THE BROADER SCOPE OF THE 2020 CODE AND HOLISTIC-RISK ENGAGEMENT

The possibility that strategic issuer-specific engagement by defensive institutional investors is a lost cause may have persuaded the FRC to take the concept of stewardship engagement outside of its comfort zone. The 2020 Code envisages that it should be incumbent on institutional investors to disclose how they

157 Lund (2018), *ibid*, 521 – passive funds may be deterred from supporting activist campaigns due to conflicts of interest (in particular, if the relevant engagement in the issuer could have a detrimental effect on the performance of other issuers that compete with the relevant issuer and form part of the fund's portfolio), and the need to expend at least some costs in assessing the proposal.

158 2020 Code, n 2 above, Principle 10.

159 For example the asset managers, State Street, BlackRock and Legal & General already voluntarily make disclosures of this nature (State Street, *Stewardship Report 2018-19* 92; BlackRock, *2019 Investment Stewardship Annual Report* 23; Legal & General, *2019 Active Ownership Report* 26). Greater recognition of the offensive activist dynamic by the Stewardship Code could harmonise the detail, substance and value of such disclosures.

160 Unlike previous versions of the Code, Principle 10 of the 2020 Code, which relates to collaborative engagement, no longer requires the disclosure of policies on collaborative engagement, and, instead, the reporting expectations only require disclosure of activities and outcomes.

promote well-functioning markets by identifying and responding to systemic and market-wide risks,[161] and integrate stewardship (including material ESG and climate change issues) into their investment approaches.[162] The new slant to the 2020 Code could, in some respects, save the Code as an aid to engagement, albeit in a different format to what was originally envisaged. The 2020 Code defines market-wide risks as risks that lead to financial loss across the entire market, and systemic risks as risks that lead to the collapse of an industry, financial market or economy;[163] in the remainder of this article, they shall be described singularly as 'holistic-risks', being matters that affect a substantial number of companies or whole industries. Holistic-risks could, for example, include changes in interest rates, economic downturns, credit crunches, pandemics, and climate change.

Unlike issuer-specific risks, holistic-risks, which affect multiple portfolio companies, can not be hedged through diversification of the equity portfolio.[164] Therefore, for an active investor, it may well be in the interests of beneficiaries and clients to conduct engagement, of sorts, with issuers on holistic-risks. Although costs are incurred in developing policies on which, and how, holistic-risks should be mitigated by issuers, in the event of those risks emerging, the potential gains, accrued across the portfolio, can be considerable. Furthermore, if the relevant risk crystallises, for an active investor, a competitive advantage can, in some cases, be garnered compared to other asset managers that have not so engaged, since, presumably, those issuers that do not disclose the implementation of the necessary risk-mitigation measures after engagement will be omitted from the relevant portfolio of the engaging investor. Such a hold-or-exit strategy chimes with the 2020 Code's new imploration that signatories incorporate material ESG and climate change issues (amongst other stewardship aspects) into their investment approaches,[165] including acquisition and hold decisions.[166] Costs are also low; rather than forensic analysis of individual companies, engagement can be conducted by the investor simply by publicly stating the level of disclosure expected from issuers, and the measures that the investor expects issuers to put in place to mitigate against specific holistic-risks. The low-cost nature of holistic-risk engagement is evidenced by BlackRock's (the leading asset manager, by assets under management, of UK assets in equities[167]) recent declarations on climate-change.[168] In identifying climate change as an investment risk, BlackRock has notified investee companies that it expects them to

161 2020 Code, n 2 above, Principle 4.
162 *ibid*, Principle 7.
163 *ibid*, Principle 4 – Reporting Expectations: 'Outcome'.
164 Gilson and Gordon, n 93 above, 869, fn 17; Jeffrey Gordon also made a similar remark specifically regarding the 2020 COVID-19 global pandemic at the European Corporate Governance Institute webinar 'The COVID-19 Crisis and its Aftermath: Corporate Governance Implications and Policy Challenges' (16 April 2020).
165 2020 Code, n 2 above, Principle 7.
166 *ibid*, Reporting Expectations: Outcome.
167 See Figure 2. Blackrock is also the leading asset manager of US equities (J. Fichtner, 'Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk' (2017) 19 *Business and Politics* 298, 304).
168 L. Fink (Chair and Chief Executive Officer of BlackRock), '2020 letter to CEOs' 14 January 2020 at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

make disclosures in line with the requirements of the Sustainability Accounting Standards Board (SASB)[169] and the Task Force on Climate-related Financial Disclosures (TFCD).[170] Such disclosures by issuers should give institutional investors sufficient information to ascertain issuer-exposure to the relevant holistic-risk, and even without subsequently expending costs in examining whether an issuer has in fact implemented the measures that it has disclosed it has implemented, the investor can secure at least a degree of comfort.[171]

In contrast, for passive investors, as with issuer-specific engagement, the incurrence of any costs in holistic-risk engagement that are disproportionate to the costs being expended by competitors will place the passive fund in a worse position than competitor investors. Even though, compared to issuer-specific engagement, the potential gains are much higher for holistic-risk engagements that affect multiple companies, passive investors cannot derive a competitive benefit, since the benefits of successful engagement will accrue to all competitor passive investors, and, unlike active investors, the engaging passive investor cannot react to unsuccessful engagement by exiting the relevant investments. Therefore, it is unlikely that passive investors will exercise any substantive holistic-risk engagement, and will, instead, free-ride on the successful holistic-risk engagement efforts of active investors. That does not mean that passive investors are completely disconnected from the process, though, since passive investors can still play a part in active investor holistic-risk engagements by voting, or threatening to vote, their shares in favour of active investor engagement proposals. Additionally, the juxtaposition between active and passive investors when it comes to holistic-risk engagement is not cut-and-dried.[172] The largest asset managers run both active and passive strategies for various clients. As such, holistic-risk engagement can be undertaken on an institutional basis in a manner that benefits both active and passive funds,[173] with costs especially low, since the institutional investor will be supporting market-wide initiatives

169 SASB is an independent standards board that has formulated a set of reporting standards on sustainability topics.

170 TFCD, established by the Financial Stability Board, develops voluntary climate-related financial risk disclosures. Recently, the FCA published forthcoming rules pursuant to which premium-listed companies will be mandated, under the Listing Rules, to disclose their adherence to the TFCD reporting requirements on a comply-or-explain basis (FCA, 'Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations' Policy Statement PS20/17, December 2020).

171 Directors of companies incorporated in England and Wales are liable for any misleading statements in directors' reports (CA 2006, s 463). Additionally, the making of false or misleading statements with, for example, the intention to (or recklessly as to whether it may) induce another person to exercise, or refrain from exercising, any rights conferred by a relevant investment, is a criminal offence under FSMA 2000, s 89.

172 Fisch, Hamdani and Davidoff Solomon, n 90 above, 43.

173 Large asset managers may not distinguish holistic-risk expectations between active and passive funds (B. Novick et al (BlackRock), 'Investment Stewardship Ecosystem' *Harvard Law School Forum on Corporate Governance* 24 July 2018), and divergence in voting preferences between individual funds managed by the same asset manager is rare (Griffith, n 72 above, 19). Some of the conflicts that deter issuer-specific engagement on an institutional basis (n 95 above) are less likely to be apparent with holistic-risk engagement, since holistic-risks are more likely to affect multiple asset-types.

across a number of issuers.[174] Engagement of this nature can be particularly effective given the concentration of asset management in the UK. In 2017, the twenty largest global asset managers controlled 21.97 per cent of FTSE-350 companies.[175] Such concentration means that when the largest asset managers express their views on holistic-risks, issuers will tend to listen,[176] and, in line with the aspirations of the 2020 Code,[177] institutional investors can, indeed, contribute to well-functioning financial markets.

Holistic-risk engagement is not just a theoretical likelihood for institutional investors – it also manifests itself in real-world examples. Figure 1 outlines examples of disclosed holistic-risk engagements conducted by BlackRock, Vanguard and State Street, the three largest (by assets under management) asset managers of equities in the US,[178] and also by Legal & General and Baillie Gifford, who, together with BlackRock, are the three largest asset managers of UK institutional assets invested in equities – as shown in Figure 2, those three asset managers dominate the top 20 managers of UK-assets in global equities. When institutional investors engage on matters beyond mere governance, executive pay and takeover matters, the issues are more commonly holistic-risk based rather than issuer-specific.[179] However, the disclosures of holistic-risk engagement in Figure 1 derive from reports that have not been published in response to any specific regulatory requirement or code, and, in particular, are separate from other reports that have been produced by those institutional investors in support of their disclosure obligations under the Stewardship Code. Active asset managers are incentivised to conduct holistic-risk engagements since they are clearly in the interests of clients and beneficiaries[180] (and, therefore, in the commercial interests of the institutional investors from the perspective of attracting business) whether or not the Stewardship Code encourages such behaviour. Therefore, in terms of encouraging holistic-risk engagement, the 2020 Code may, in its current form, have little impact, but the purpose of the Code's broader

174 Fisch, Hamdani and Davidoff Solomon, n 90 above, 39. However, the capacity for passive funds to benefit from free-riding on active fund engagement within the same institution is limited by the fact that active funds invest in fewer issuers than passive funds (Strampelli, n 88 above, 825).

175 Gomtsian, n 114 above, 9. As regards concentration, also see Figure 2.

176 Fisch, Hamdani and Davidoff Solomon, n 90 above, 40; Sushko and Turner, n 91 above, 121, fn 13. Additionally, it is more effective for small numbers of large shareholders to engage with issuers, rather than large numbers of asset managers with, potentially, divergent views (L. Strine, 'Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law' (2014) 114 CLR 449, 475).

177 n 161 above, and accompanying text.

178 Fichtner, n 167 above, 304.

179 Vanguard has disclosed some issuer-specific engagements, but they were reactionary rather than proactive strategy-related engagements (Vanguard, *Investment Stewardship 2019 Annual Report* 21). Indeed, Vanguard specifically states: 'We don't seek to dictate strategy. Rather, we want to know that critical issues are being addressed.' (*ibid*, 12). Baillie Gifford has also disclosed a handful of issuer-specific engagements, but detailed examination suggests that these were mainly governance- and executive remuneration-related (Baillie Gifford, *Global Stewardship: Governance and Sustainability Report 2019* 26-33).

180 The Law Commission notes that taking into account 'macroeconomic factors' that affect the portfolio as a whole is not a breach of trustees' fiduciary duties, as long as the costs do not outweigh the benefits (Law Commission (2013), n 55 above, 153). However, also see n 181 below.

Institution	Sources	Holistic Engagement Examples
BlackRock Inc	*2019 Investment Stewardship Annual Report*[a] and B. Novick *et al* (BlackRock), 'Investment Stewardship Ecosystem' *Harvard Law School Forum on Corporate Governance* 24 July 2018[b]	Engagement with palm oil producing companies relating to potential regulatory risks associated with environmental and social issues attached to the manufacture of palm oil. Ensuring that investee companies across the pharmaceutical industry had implemented adequate risk management with respect to the US opioid epidemic (including in relation to potential public policy changes). Improving disclosure of how climate-related risks had been mitigated across investee companies in the energy sector.
The Vanguard Group	*Investment Stewardship 2019 Annual Report*[c]	Engagement with energy companies on climate-change risks.
State Street Corporation	*Stewardship Report 2018-19*[d]	In the past five years, engagements have focused on cybersecurity risks, supply chain management risks, environmental management, and water management.
Legal & General Investment Management	*2019 Active Ownership Report*[e]	The majority of engagements in 2019 were related to climate-change risks, including companies in the oil and gas, and utilities sectors.
Baillie Gifford	*Global Stewardship: Governance and Sustainability Report 2019*[f]	'Carbon intensity' of holdings and their exposure to regulation and changing customer perceptions is factored into selection and weighting processes. Monitored large internet platforms on customer data handling issues in the context of the threat of external regulation.

Figure 1: Examples of holistic-risk engagements by the largest asset managers of equities in the UK and US.

scope may, more rationally, be related to securing better quality disclosure on holistic-risk engagement.

The question remains, though, as to whether the 2020 Code will elicit adequate disclosures of holistic-risk engagement. Clients and beneficiaries will have an interest in knowing which holistic-risks are prioritised by institutional investors so that, at least in relation to active investments, they can make investment decisions based upon their views as to whether the relevant institutional investor is protecting against the appropriate holistic-risks or being too cautious with respect to a holistic-risk that is doubtful to ever emerge.[181] Currently, Principle 4, which expressly references market-wide and systemic risks,[182] requires signatories to disclose their activities in relation to those risks (meaning examples of where they have taken those risks into account), and the outcomes of

181 The Law Commission notes that trustees should not consider 'macroeconomic factors' to the extent that the financial benefits are too remote (Law Commission (2013), n 55 above, 153).
182 n 161, and accompanying text.

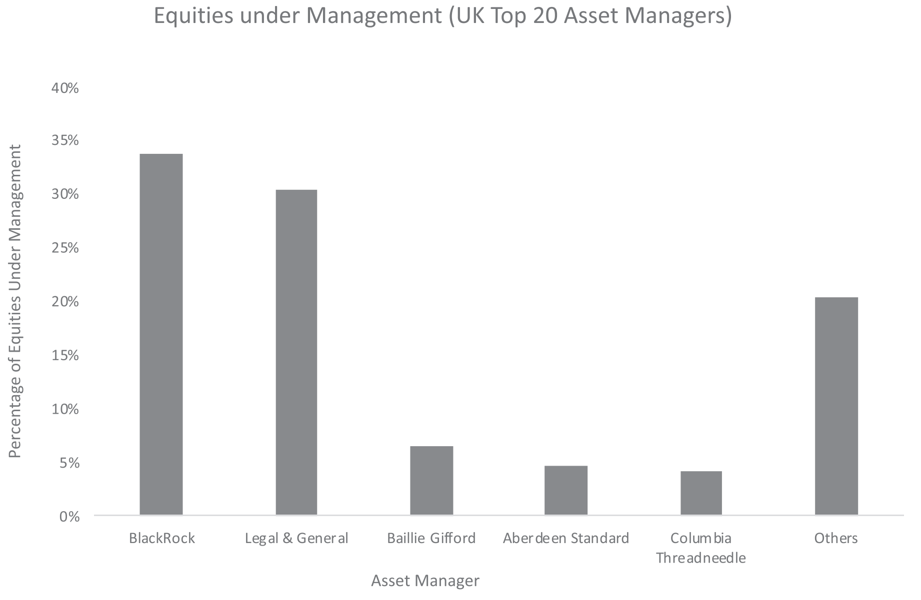

Figure 2: Equities under Management (UK Top 20 Asset Managers) (data source: Investments & Pensions in Europe Magazine (September 2019) 46).

those activities (meaning the effectiveness in responding to those risks). There is no express requirement to inform clients and beneficiaries of their policies in relation to holistic-risks, or which holistic-risks are prioritised and how they are taken into account; the approach of Principle 4 reflects the underlying premise of the Principle which is to 'promote a well-functioning financial system', rather than to encourage holistic-risk engagement specifically. One could read into Principle 7 (the requirement to integrate stewardship and investment[183]) that there is an expectation on signatories to disclose the issues that they have prioritised in assessing investments,[184] which could potentially generate relevant disclosures on holistic-risk engagement policy, but, again, the reporting expectations are far broader than (and will likely result in equally broad disclosures), and do not specifically reference, holistic-risk engagement.[185] Principle 7's broader nature betrays its provenance, which is to encourage greater consideration of ESG factors by market participants, rather than holistic-risk engagement specifically. Rather than, as currently required by the Code, focusing on disclosures relating to issuer-specific engagement, that does not regularly occur in a meaningful way, beneficiaries and clients would better benefit from more explicit disclosures relating to holistic-risk engagement, which does occur in practice. In particular, specific disclosures regarding which holistic risks are prioritised and how they are factored into engagement would be valuable. Additionally, the disclosure framework on holistic-risk engagement should be further developed

183 n 162, and accompanying text.
184 2020 Code, n 2 above, Principle 7 – Reporting Expectations: Context.
185 Principle 7 embraces a much broader aspiration than holistic-risk engagement, and urges institutional investors to integrate stewardship matters, such as ESG and climate change, into buy, hold and exit decisions in alignment with the investment time horizons of beneficiaries.

to specifically require disclosure by institutional investors as to how and in what circumstances they will support holistic-risk mitigation measures proposed by other investors. Similar to the proposals made above with respect to offensive activist campaigns,[186] such disclosure will give beneficiaries and clients clearer information as to which holistic-risks are of concern to asset owners and asset managers. In the bigger picture, even such disclosure by passive investors can be instrumental, since if passive investors disclose that they will support judicious proposals by other investors on certain holistic-risk issues, issuers will be more likely to respond positively to engagement by other investors in the knowledge that passive funds, with their increasing share of voting rights,[187] will support the relevant engagements.[188] Active investors would, correspondingly, be encouraged to engage, and holistic-risk engagement should become more prevalent across the market.

Even though Kingman has expressed scepticism that institutional investors are engaging with issuers, in fact, holistic-risk engagement, which is arguably more beneficial in the wider context than engagement on issuer-specific matters, may be alive and kicking. The FRC appears to have belatedly woken-up to that understanding, and, as with disclosures related to the support of offensive activist engagement discussed above, it is now time that any regulatory disclosure requirements are tailored specifically to the types of engagement that will actually take place.[189]

CONCLUSIONS

The 2020 Code is the first substantial up-date of the Stewardship Code since its genesis in 2010, and it continues its mission to promote proactive issuer-specific engagement by institutional investors on strategic issues as implored by the Walker Review, and pursuant to the final warning to enhance effective engagement notified by the Kingman Review. However, the diversification of portfolios by institutional investors, the competitive environment in which

186 See 'Putting issuer-specific engagement into context' above.
187 n 89 above.
188 Large asset managers engaging on an institutional basis will also significantly enhance the influence of holistic-risk engagement (n 173 above, and accompanying text).
189 The FRC is not the only regulatory body that has been enlightened in this regard – outside the UK, the EU has implemented mandatory disclosure requirements, effective as of March 2021 (Regulation (EU) 2019/2088, n 82 above, Art 20), for 'financial participants', including asset managers, insurance companies and occupational pension schemes (*ibid*, Art 2), to make sustainability-risk related disclosures. A 'sustainability-risk' is 'an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment' (*ibid*, Art 2), and disclosures are required in relation to the extent to which sustainability risks are integrated into investment decision-making (*ibid*, Art 3(1)) (unless they are deemed not relevant in which case the reasons therefor must be disclosed), and the likely impacts of sustainability risks on returns (*ibid*, Art 6(1)(b)). Although the EU's regulatory agenda stems from a desire to ensure that the financial system supports sustainability, such as environmental goals, it is clear that the EU does not view holistic-risk engagement as a lost cause, with an assumption that beneficiaries will encourage asset owners to exercise such stewardship based upon disclosures that clearly link such engagement (or the lack thereof) to the relevant portfolio's financial returns.

they exist, and the uncertainties surrounding the success of any proposed engagement mean that issuer-specific engagement will rarely be in the interests of asset owners or asset managers, or, importantly, given the duties owed by them, in the interests of their beneficiaries and clients, respectively. No matter the efforts of the Stewardship Code, institutional investors will seldom proactively engage on issuer-specific matters other than on low-cost governance, and disclosures in relation thereto are often superfluous. Even worse, continued coercion of institutional investors to conduct issuer-specific engagement could simply escalate box-ticking governance or uninformed engagement that potentially damages issuers. Although outside the scope of this article, the traditional forms of engagement coveted by the Walker and Kingman Reviews will only proliferate if institutional investors are placed under mandatory legal or regulatory impositions (rather than the voluntary soft-law encouragement of the 2020 Code) such that all institutional investors are required to engage, negating the competitive benefits of free-riding; but, even then, it is difficult to envisage how such requirements would operate or be enforced in any practical sense.

Disclosure relating to engagement is not, though, completely without merit, and outside the realms of 'Walker-recommended' issuer-specific engagement, the disclosure environment could be improved in two respects. Firstly, there should be greater recognition that the principal actors with an incentive to conduct issuer-specific engagement are offensive activists such as hedge funds. Since they require support from other institutional investors, disclosure by all such investors as to how, and when, they will support activist campaigns would be salutary. Second, there should be greater focus on ensuring that institutional investors disclose which systemic and market-wide risks they consider important and how they are manifested in real-world engagement. Unlike issuer-specific engagement, incentives exist for institutional investors to engage on such holistic risks, and related disclosure will be beneficial to both clients and beneficiaries.

Critically, issuer-specific engagement by offensive activists and holistic-risk engagement by active investors will generally occur whether or not encouraged by the Stewardship Code, and, in fact, the Code will have very little impact on whether or to what extent such engagement actually occurs. Instead, the Code's future approach, if it is not too late, should be to ensure that disclosures are made by institutional investors in relation to the types of engagement they exercise or support in a manner that will be informative to potential beneficiaries and clients. Whether the Stewardship Code is the appropriate forum for such requirements is a discussion for another day, but, notably, in the EU, disclosure requirements related to stewardship are taking on more of a mandatory character.[190] However, taking the 2020 Code on its face, it is difficult to see how it will encourage further engagement in the manner requested by the Kingman Review, and its broader focus unveils an acknowledgment by the FRC that the 2020 Code is grappling for greater relevance in the face of a losing battle to encourage more issuer-specific engagement by institutional

190 nn 82 and 189 above.

investors. Eventually, the emperor's subjects were no longer fooled by invisible clothes; in the same way, there has been a dawning realisation that attempting to use soft law to compel institutional investors to take actions that do not correlate with their duties and commercial interests is an illusory endeavour, and it is now time to focus on the types of engagement that actually occur.